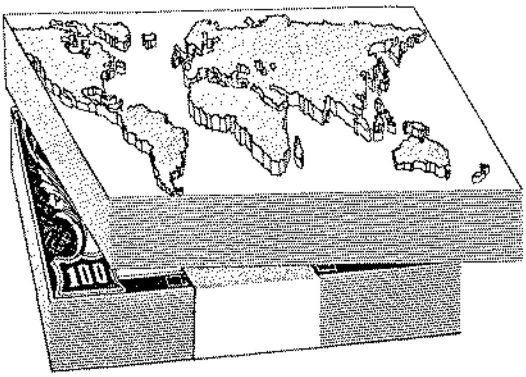
Ashcroft, Brian and Walker, Jim and Boyle, Stephen and Draper, Paul and Harrigan, Frank and Heeley, John and Jenkins, Iain and Lockyer, Cliff and Love, Jim H and McGregor, Peter and McNicoll, Iain and Perman, Roger and Simpson, David (1987) The world economy [February 1987]. Quarterly Economic Commentary, 12 (3). pp. 4-9. ISSN 2046-5378 ,

The World Economy



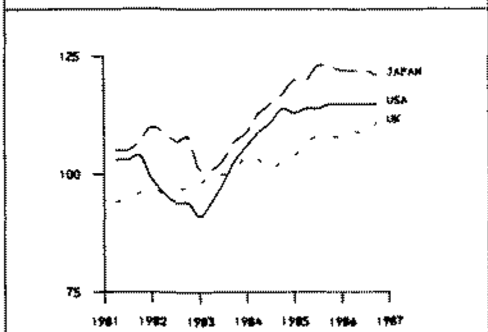
OVERVIEW

Further marginal improvements in output growth, unemployment and the rate of inflation have been recorded as the benefits of lower oil prices and reduced inflationary expectations worked their way through the world economy. However, the continuing current account imbalances between the US, Japan and West Germany, and the failure of the principals to reach an agreement on the best way of dealing with them, constitute the main threat to trade stability and future economic growth.

MACROECONOMIC TRENDS

In the third quarter of 1986 **industrial production** in the OECD countries rose slightly by just under 1%, following a period of relative stagnation in the first two quarters of the year. The growth of US output, which had been the main depressing influence on aggregate performance during the earlier part of the year, showed some signs of improvement. US industrial production rose by about 0.5% between the second and third quarters, compared with a fall of the same magnitude in the second quarter. The European OECD countries continued to expand, as the benefits of lower oil prices and interest rates began to have an impact on domestic production. Third quarter industrial production rose by a further 1%, following the 0.5% increase during the previous three months. In contrast, Japanese output growth became the main depressing influence as industrial production fell by more than 0.5%, reflecting the deflationary effects of the high value of the yen. By October total OECD industrial production had risen by 1.2% during the preceding twelve months, with US production exhibiting a small increase of 0.9%, Japan and West Germany's production **falling** by 0.9%, in both cases, and production in the European OECD countries rising by 1.8%.

INDICES OF INDUSTRIAL PRODUCTION
SEASONALLY ADJUSTED (1980=100)



The outlook for the **US economy** is governed by considerable uncertainty. After four years of continued expansion, growth slackened in 1986. Gross national production (GNP) grew at a real annual rate of 3.8%, 0.6%, 2.8% and 1.7%, respectively, in successive quarters. Growth in the third quarter was heavily dependent on a rapid increase in car sales following the availability of low interest loans. The economy therefore grew by 2.5% during the twelve months to the end of 1986, which represents a significant shortfall on the US Administration's original forecast of 4% for the year. The November **Commentary** noted that subsequent events had caused the government to revise its growth expectations downward, first to 3.2% and then finally to 2.7%.

The effect of lower oil prices on the domestic oil industry, weakness in the farming sector (as international changes occurred in the structure of agriculture) and a downturn in gross private domestic fixed investment from the fourth quarter of 1985, contributed to the faltering in growth. Yet domestic final demand remained buoyant, at least to the third quarter of the year. Between the third quarters of 1985 and 1986, real GNP rose by only 2.3%, whereas domestic demand increased by 3.8%. Indeed, during the first three quarters of 1986 real GNP grew at an annual rate of 1.7% compared with a 6.2% rate of growth of domestic demand. A substantial part of demand growth was, in consequence, channelled into increased net imports, resulting in a further expansion of the trade deficit which continues to be the principle constraint on the growth of domestic demand.

From late 1979 the dollar rose substantially against the major trading currencies, reaching a peak at the beginning of 1985. During this period the deutschemark-dollar rate, for example, rose from about 1.7 to 3.4. Since this appreciation did not reflect a real improvement in competitiveness but was simply the unintended outcome of domestic fiscal and monetary policies the trade deficit suffered a marked deterioration. From 1982 the annual trade deficit in the US rose progressively from US$36.4bn to US$124.4bn in 1985. During 1986 the deficit increased further to over US$170bn and was still at record levels in the third quarter of the year when the quarterly deficit rose to US$37.67bn, compared with outturns of US$36.5bn and US$36bn in the first and second quarters, respectively.

Since the beginning of 1985 the dollar has depreciated markedly. Over the period the dollar has fallen against the yen and deutschemark by over 40% and nearly 50%, respectively. After a brief period of stabilisation the dollar fell by 7% against the yen and 9% against the deutschemark in the month to the middle of January this year. The apparent failure of the trade deficit to respond to the fall in the exchange rate has led to growing protectionist pressures within the US which, despite initial resistance, has led the Administration to take a harder line with its trading partners and maintain its calls for domestic reflationary measures by the Japanese and West German governments. The recent disputes between the US and the EC over US grain sales to Spain and alleged excessive government subsidies to the European Airbus programme, are evidence of this tougher trade policy stance. A continued lack of improvement in the trade deficit is likely to make it almost impossible for the Administration to resist the imposition of selective protectionist measures or even a general import surcharge. However, as noted in previous **Commentaries**, the so-called J-curve effect, which reflects the prices of traded goods reacting more quickly than trade volumes to exchange rate changes, suggests that the trade balance should improve during 1987, and some analysts believe that inadequate trade statistics hide an improvement that is already underway. In addition, the ability of Japanese exporters to the US to absorb the dollar price effects of the depreciation, by a lowering of previously high profit margins, has been severely eroded by the continuing effect of the appreciating yen on profit margins. Increases in the dollar prices of Japanese products should serve to switch some US domestic demand away from these goods, which in 1985 accounted for 19.4% of US imports.

Further improvements in the US trade deficit will follow if proposals to reduce the US Budget deficit, and hence the domestic savings shortfall, (see November **Commentary** are realised. The Budget presented by President Reagan to Congress at the beginning of January envisages a reduction in the deficit from the record US$220.7bn reached in the 1986 fiscal year to US$173.2bn in fiscal year 1987 which began last October. The projected deficit for fiscal year 1988 of US$107.8bn is just below the target set by the Gramm-Rudman-Hollins budget reform law, but many analysts believe that the projection is based on a mixture of both creative accounting and over-optimistic assumptions about US economic growth. Nevertheless, with projected reductions in the Budget deficit and the recent, expected downturn in consumer spending, there are fears for US growth despite the US Administration's forecast of a 3.2% rate of expansion during 1987, and the big increase in the index of leading economic indicators in December. The outcome depends crucially on what happens to the trade deficit.

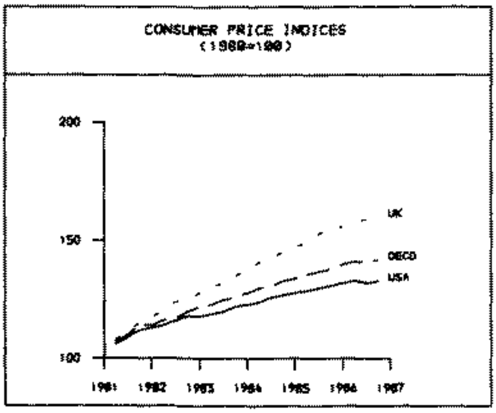
After falling by 0.4% in the first quarter of 1986, **Japanese** real GNP rose by 0.9% and 0.6% in the second and third quarters, respectively. Growth in the Japanese economy continues to be constrained due to the deflationary effects of the 40% appreciation of the yen against the dollar since the second quarter of 1985. By October of last year both industrial production and manufacturing output had declined by 0.9% and 1%, respectively, over the preceding twelve months. Non-exporting sectors, on the other hand, have probably benefited from the cost reductions following the yen's appreciation and lower oil prices. Real income gains have been sluggish because the lower oil price has not yet fed through to consumer prices, although producer prices have clearly been affected. Increased public investment has also favoured the non-manufacturing sector. Export volumes have continued to decline and import volumes increase, but the J-curve effects of the appreciating yen produced successive increases in the current account surplus throughout 1986. By the third quarter the surplus stood at US$24.2bn, almost twice as high as the first quarter surplus, indicating a record US$90bn surplus for fiscal year 1986. Experts predict a gradual reversal of this trend as the J-curve effects unwind or if, the yen stabilises against the dollar, although the current account surplus is still expected to be nearer US$90bn rather than US$80bn in fiscal year 1987.

Pressure on the Japanese Government to stimulate the growth of domestic demand has continued. Following the reduction in the official discount rate in three successive stages, from 5% to 3.5%, between January and July 1986, a further cut of 0.5% points occurred after the Baker/Miyazawa currency stabilisation accord last October. Further declines in the yen-dollar rate to Y150 led to a reaffirmation of this agreement at a meeting between Mr Miyazawa and Mr Baker in late January of this year and a subsequent cut in the discount rate to 2.5%. But most experts believe that the cut will have little impact in raising domestic demand. The government's proposed budget for fiscal year 1987 provides little stimulus to the economy and the government now appears to recognise that a further fiscal stimulus will be required, both to prevent the effects of the appreciating yen from precipitating a deflationary spiral and to forestall further US criticism and possible protectionist measures. However, it is expected that little can be done before April. In the meantime, on current policies, the economy is expected to grow by little more in fiscal year 1987 than the anticipated 2.2% achieved during fiscal year 1986.

In January, severe downward pressure on the French franc relative to the deutschemark spread to other currencies in the European Monetary System (EMS) and led to a decision by the **West German** Government to revalue the deutschemark against other EMS currencies. A cut in key interest rates of 0.5% points followed an attempt to restrict the rise of the deutschemark which had stayed firm in the EMS despite the revaluation. Funds had moved into deutschemarks as the dollar fell. The Bundesbank also moved to increase its control over monetary growth by squeezing excess liquidity with a 10% increase in bank's minimum reserve requirements and a DM8bn reduction in rediscount facilities. Many observers still believe that current and projected growth is still below the economy's potential. On current policies, West Germany's five leading economic research institutes forecast that growth is likely to slow down during the second half of 1987 as a result of the diminishing influence of the reduced price of oil and tax cuts. A provisional estimate of almost zero economic growth in the fourth quarter of 1986 has resulted in four of these institutes revising their forecasts downwards. The likely outturn for 1987 is now expected to be little more than 2%.

Owing to J-curve effects and the impact of improved terms of trade following lower oil prices, West Germany's nominal trade surplus rose progressively throughout 1986, from DM24.9bn, to DM27.9bn and DM31.5bn, in the first, second and third quarters respectively. Current forecasts suggest that the surplus, on both trade and current accounts, will only be slightly lower during 1987 than in 1986. Yet Dr Kohl's coalition, with the election victory behind it, appears still to be resisting pressures for an early fiscal stimulus, largely because of inflationary fears and uncertainties about the effects of the deutschemark's appreciation on the balance of payments.

Inflation in the world economy continued to edge downwards during the latter part of 1986. By November, the rate of change in consumer prices over the preceding twelve months stood at 2.2% in OECD countries, the lowest rate since April 1964. In the year to August the rate was 2.4%. Significant variations in inflation rates continue between the principal economies of the OECD. Both Japan and Germany continue to experience negative inflation rates with prices falling by 0.3% and 1.2%, respectively in the year to November.



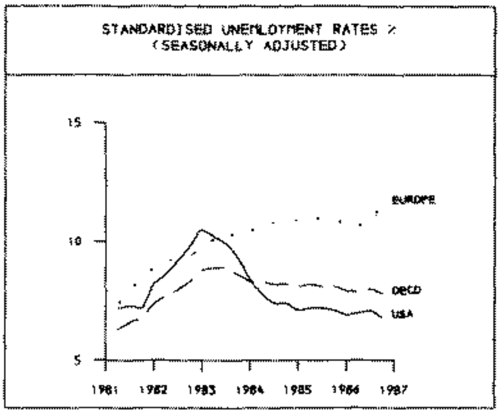
For the US, the rate of price change to November was slightly lower at 1.3% than the 1.6% recorded in the year to August. As suggested in the November **Commentary**, the low inflation rate in the US, despite significant falls in the value of the dollar, provides further indirect evidence of importers into the US responding to the dollar's depreciation by reducing profit margins. Other reasons for the comparatively low inflation rate in the US, despite the depreciating dollar, include: the still low proportion of imports to domestic production, and the apparent unresponsiveness of earnings and pay settlements to declining real wages. US workers, on average, received weekly earnings in 1986 which were 8.5% lower in real terms than in 1970 and, in 1986, the number of US workers who were subject to pay cuts or freezes rose markedly. In OECD Europe and the EC, where labour market conditions are less flexible, the annual rate of inflation to November stood at 3.8% and 2.9%, respectively, a slight reduction on the annual rates to August reported in the November **Commentary.**

The future course of oil prices will continue to be the key influence on inflation rates during the year. Following the apparent shift of emphasis in Saudi policy towards higher prices rather than higher production and recovery of market share, the November **Commentary** predicted that the prospect for a longer-term agreement between OPEC members on production levels and quotas was more probable. At the OPEC meeting in Geneva in December, twelve of OPEC's 13 members, the exception being Iraq, agreed to limit output to 15.8m barrels per day during the first half of 1987 and fix prices around a central reference of US$18 a barrel. The new agreement compares with a production level of 17.3m barrels per day and a price per barrel of around US$15 in the weeks preceding the agreement. The failure to get Iraq to agree to a quota suggests that production could in fact be higher than the agreed limit, with some reports suggesting that output could average 16.5m barrels per day if Iraq pumped to its maximum available export capacity; an estimate which assumes that the other twelve members of OPEC would not exceed their quotas. Whether the price will stabilise at around US$18 depends not only on OPEC production but also on the responses of non-OPEC producers and the rate at which the high levels of stocks held by oil consumers are run down (see Oil and Gas section in Industrial Performance).

LABOUR MARKET

In the third quarter of 1986, the standardised rate of **unemployment** in the

OECD countries fell slightly to 7.8%, compared with 8% and 7.9% in the second and first quarters respectively. In the US, the turnround in the downward movement of the rate, following the earlier deceleration in US growth, appears to have ceased. Third quarter unemployment fell back to 6.8% after successive increases from 6.9% in the fourth quarter of 1985 to 7% and 7.1% in the first and second quarters of 1986. Unemployment in OECD Europe and the EC continues to be high and largely unchanging, with the third quarter rates of 10.6% in the former and 11.5% in the latter, almost identical to the rates prevailing on average in both 1984 and 1985. Within Europe, unemployment continued to fall in West Germany reaching 8.2% in the third quarter, compared with an average of 8.4% during the preceding two quarters. France experienced a slight increase in unemployment to 10.4%, while Italian unemployment fell back to 10.7% from the second quarter peak of 11.3%. In the UK, the rate of 11.5% represented a slight reduction on the previous quarter's figures.



STANDARDISED UNEMLOYMENT RATES %
(SEASONALLY ADJUSTED)

Despite the marked appreciation of the yen and the contraction of industrial production over the past year, unemployment in Japan remains under 3%. By November, standardised unemployment stood at 2.8%, 0.1% points lower than the average for the third quarter and only slightly higher than the 2.6% and 2.7% rates recorded in the first and second quarters. Japan's ability to avoid substantial lay-offs during periods of contraction reflects the flexible labour market practices that are a feature of the country's industrial culture. Earnings flexibility comes from the importance of the system of twice-yearly bonus payments which accounts for a quarter of the average Japanese worker's annual pay and which can readily be adjusted downwards when profits fall. In addition, the principle of flexible job assignments and the acceptance of intra-firm, and sometimes agreed inter-firm, work mobility, allows workers to be redeployed to other tasks. Both features of the system provide a buffer which helps to preserve jobs without prohibitive cost during times of economic contraction. However, the realisation by many Japanese companies that the deterioration in their international competitiveness is unlikely to be reversed for the foreseeable future, coupled with projected growth in the labour force, may put the system under strain. The recent rash of redundancy announcements appears to be pointing in this direction, but it is nevertheless clear that many lessons can still be learned in Europe from Japanese labour market experience.

PROGNOSIS

Recent data suggest that the world economy has experienced marginal improvements in output growth, unemployment and the rate of inflation. Growth in the industrialised countries has been slow to respond to the fall in oil prices and the fall in inflationary expectations. Despite the fall in the dollar, the problem of substantial current account imbalances between the US, Japan and West Germany, still remains. Protectionist pressures within the US have increased and the US Government has felt it necessary to adopt a tougher trade policy stance towards its principal trading partners. The prospect of the US introducing further selective trade restrictions, or even a general import surcharge, has undoubtedly increased over recent months and remains high on the political agenda. The debt problems of the developing countries continue, particularly in Latin America, although some headway has been made here following the agreement in late January to reschedule US$4bn of Brazilian debt, and Japan's pledge in December to provide US$9bn to leading aid agencies.

Further improvements in growth must be expected over the coming months but the benefits of lower oil prices are likely to dissipate by the middle of the year especially if the oil price holds at US$18 per barrel or above. The failure of the US, Japan and West Germany to agree an acceptable policy on the most appropriate approach to the removal of the current account imbalances, constitutes the biggest threat to trade stability and world economic growth. In current circumstances, the pursuit of narrow national self-interest increases the likelihood of the world economy slipping back into recession. In the US, the tentative steps that are being taken to cut the massive Budget deficit have deflationary implications. It is true that a reduction in the deficit, coupled with the recent tax legislation on the supply and demand for credit, should exert downward pressure on interest rates in the US. But the effects of high real interest rates in West Germany and Japan, the dollar's depreciation and the prospective reduction in the US trade deficit are likely to reduce the supply of foreign capital tending to push up US long-term real interest rates. The US economy is therefore balanced on a double-edged sword if Budget and trade deficits contract. On the one hand, there are the deflationary effects of the declining budget deficit and the possibility of increased real interest rates, against which must be set the stimulus to domestic economic activity provided by the dollar's fall.

The Japanese Government and the West German Government, in particular, still appear reluctant to provide a domestic fiscal stimulus of sufficient magnitude to prevent further dollar depreciation and/or the burden of adjustment falling heavily on the domestic US economy. At the exchange rates ruling during the latter part of 1986, Lloyds merchant Bank calculated that to achieve a modest US$30bn reduction in the trade deficit over five years, the US economy would have to grow at half the rate achieved in the rest of the world. Clearly, in the absence of dramatic changes in US relative import propensities, at given exchange rates, and if further exchange rate instability is to be avoided, adjustment in general, and of the US Budget deficit in particular, would be easier if the Japanese and West German's adopted a significantly more expansionary policy stance. Moreover, further dollar depreciation is likely to have serious deflationary implications for both the Japanese and West German economies as both governments are belatedly beginning to realise. The argument, often advanced by the West Germans, that the current imbalances are the outcome of US fiscal irresponsibility requiring remedial policy action solely in the US, fails to allow that the most appropriate remedy may not simply be a direct reversal of the cause. A currency stabilisation agreement between the principals, coupled with a commitment on fiscal expansion by the surplus countries and a more rapid contraction of the US Budget deficit, continues to be the most pressing requirement in the world economy over the coming months.